

FINAL

**CONFERENCE OF STATE BANK SUPERVISORS
PERFORMANCE STANDARDS COMMITTEE**

**REVIEW TEAM REPORT FOR THE
RE-ACCREDITATION OF THE**

**CALIFORNIA
DEPARTMENT OF FINANCIAL INSTITUTIONS**

MARCH 27-29, 2006

**LAWRENCE E. MORGAN, TEAM LEADER
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PURPOSE/PROCEDURES OF THE EVALUATION

The primary purpose of this evaluation is to determine whether the California Department of Financial Institutions (Department) continues to fulfill its statutory responsibility to charter, examine, supervise and regulate all state-chartered commercial banks in California. The Department was first accredited in April 1990, and was re-accredited in December 1995 and March 2001. Annual reports subsequently submitted were used as a monitoring device by the CSBS Performance Standards Committee (PSC).

A Review Team of three highly experienced former regulators and the CSBS Director performed the on-site review at the Sacramento office of the Department during a three-day visit. The Review Team conducted a thorough review of the Department's recently completed Self-Evaluation Questionnaire, interviewed key personnel and a cross-section of examiners, and reviewed the products of supervision.

Starting with the on-site re-accreditation review in March 2001, the Review Team carefully assessed the changes made in each of the functional areas to determine the current level of regulation and supervision. Taking into account the changes in state-of-the-art supervision, the Team measured progress in the Department as compared to accreditation standards.

The Review Team met with Chief Deputy Carol Chesbrough, Deputy Craig Carlson, Deputy Scott Campbell and Assistant General Counsel Kenneth Sayre-Peterson on March 29, 2006, to conduct a review of the substance of this report, including all findings and recommendations.

The Review Team extends its thanks to Acting Commissioner Brian Yuen and the entire staff of the Department for the professional, courteous and cooperative attitude afforded the Team during the on-site review. The frank comments of the staff and their cooperative attitude greatly aided the Team's efforts.

CONCLUSIONS

In conducting this third re-accreditation of the California Department of Financial Institutions, the Review Team was satisfied with the overall condition of the Department, the professionalism of the staff, and the changes made since the last re-accreditation. The Department continues to meet the standards of the program and complies with program policies and goals.

The Review Team recommends that the Department be re-accredited, with continued accreditation subject to:

- Adequate responses to all Review Team recommendations within a reasonable time period (i.e., through the Annual Review process),
- Timely completion of annual reports, and
- Performance Standards Committee (PSC) approval of the annual reports and responses to previous recommendations.

SPECIFIC RECOMMENDATIONS

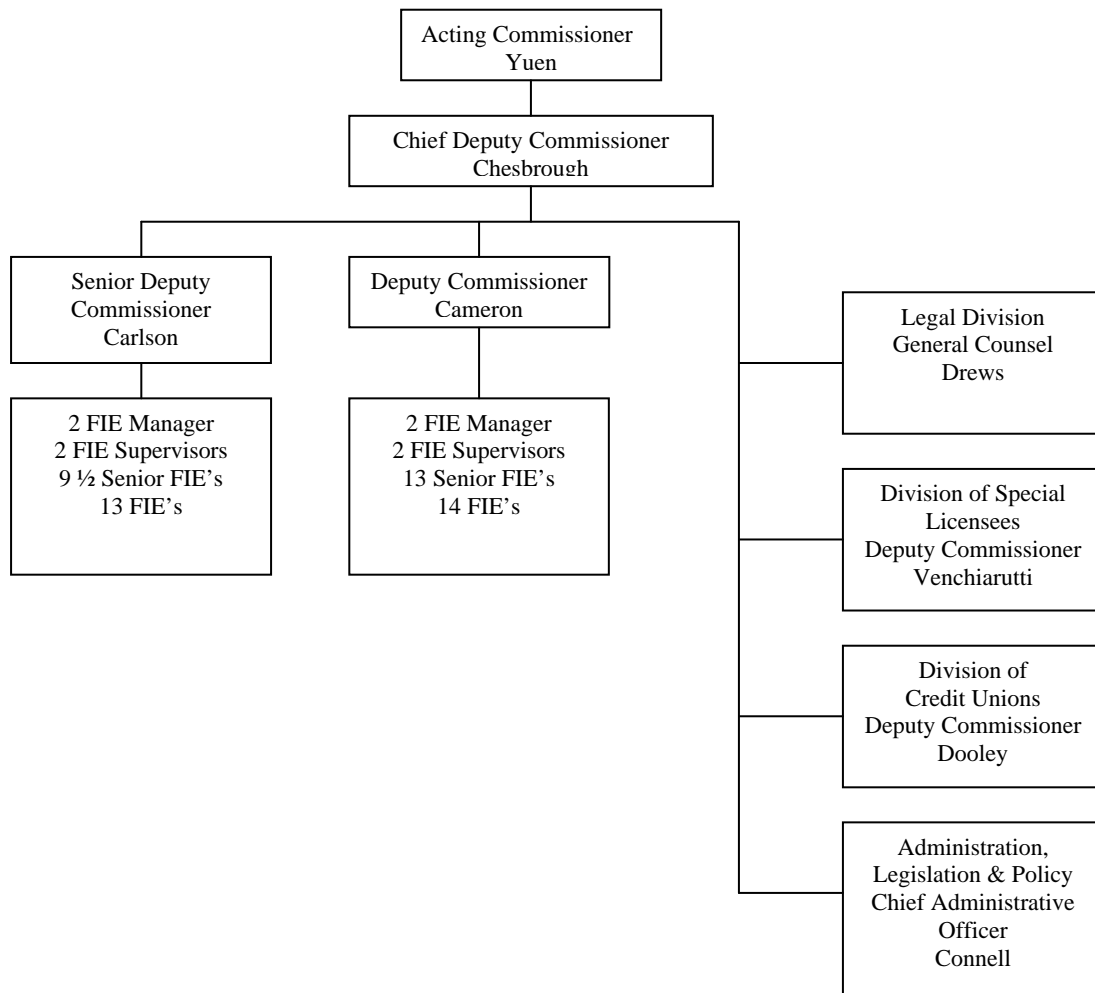
The Review Team offers the following specific issues for the California Department to address:

- Current salaries are not comparable with those paid by Federal regulators as required by the Accreditation Program “Best Practices”. Although current salaries are comparable with those paid by adjacent states, they are not comparable with those paid by states who supervise the same types and complexity of financial institutions. Additionally, the Department is currently subject to a salary freeze. The longer the freeze continues, the greater the discrepancy between salaries paid to California examiners and those paid to Federal regulators and to examiners in comparable states. Additionally, this could result in the recurrence of expensive turnover in Department staff. The Review Team recommends that the Department continue efforts to increase pay for field examiners in order to keep the salaries comparable with other regulators who perform the same type duties and responsibilities.
- The Department performs examinations of the Information Technology (IT) facilities and functions of the institutions that it regulates. The Review Team recommends that the Department also perform examinations of the independent companies that provide IT services to their regulated institutions in conformance with Accreditation Program Guidelines.
- Although the Department can examine bank holding companies, there are no direct enforcement powers over holding companies. Criminal actions can be taken by the Department of Corporations but the Department of Financial Institutions does not have enforcement powers to ensure correction of problems and violations noted during an examination. The Review Team recommends that the Department acquire enforcement authority powers over bank holding companies commensurate with those for banks.
- Back-up for laptops is done manually and there is no follow-up system to assure compliance with the back-up policy. The Review Team suggests that some process be developed to assure compliance with back-up requirements either through follow-up or automatic back-up when connected. The best method would be automatic back-up in order to eliminate possible human error when saving work intensive information.

SCOPE OF REVIEW

The California Department has responsibilities beyond the regulation of state-chartered commercial banks, industrial banks, foreign banking organizations and independent trust companies (e.g., credit unions, money transmitters, premium finance companies). The State Banking Department Accreditation Program does not attempt to analyze these other regulatory programs. The Review Team limited its review to the regulation and supervision of state-chartered commercial banks, industrial banks, foreign banking organizations and independent trust companies.

DEPARTMENT ORGANIZATION CHART



REVIEW TEAM FINDINGS

ADMINISTRATION AND FINANCE

All areas of the Department's administration and finances are adequate. The mission, goals and objectives of the Department continue to be well-defined and clearly communicated to all staff members. Input on establishing the specific goal or action is sought from all levels of staff with the Strategic Planning Committee assigned the task of developing the strategic plan.

Communications remain effective internally and include weekly meetings among senior staff and an annual meeting with all examination staff. There are currently eleven standing committees within the Department responsible for regular oversight and communication of key issues. Communications with federal and state regulatory counterparts and with trade associations also appear adequate.

Detailed procedures for promulgation of formal rules and regulations are prescribed by the California Administrative Procedures Act. Internal Department policies govern the responsibilities and time frames for applications processing. Applications are processed timely and appropriately with expedited application procedures in place for applications submitted by well-managed and well-capitalized financial institutions. The Department utilizes the Uniform Interstate Application when applicable in order to facilitate interstate branching.

The Department has adequate access to legal assistance, advice and support. There are eight attorneys employed by the Department including a General Counsel. An attorney from the Attorney General's office will represent the Department in court. When necessary, outside counsel may be hired.

The Department occupies a suite of offices in Sacramento for field examiners and administrative staff. Security in the office is adequate and includes locked entry to all offices with additional security in the confidential files office and in the Information Technology area. Adequate fire protection is in place. There are additional field offices in Los Angeles, San Diego and San Francisco. Each location has either a key card or coded entry with receptionists in the Sacramento, San Francisco and Los Angeles offices.

Information systems are provided to the Department employees through a four-office Wide Area Network (WAN) with servers located in the San Francisco, Sacramento and Los Angeles offices. The San Diego office communicates through San Francisco by router. Each office is connected via T1 lines with Internet access provided to all employees by the State's system. Each examiner has his or her own computer and email address. All examiners' computers are equipped with the software tools necessary to perform an examination and are scheduled for replacement every three years. The Department's IT recovery plan was last tested approximately six months previously. Back-up for laptops is done manually and there is no follow-up system to assure compliance with the back-up policy. Refer to the Review Team recommendations for further comments.

The Department's budget is prepared by the Budget Officer in consultation with the Chief Administrative Officer who obtains input from the Examination managers and supervisors. The Chief Administrative Officer prepares a monthly budget report and distributes it to the Executive Committee. If the Department requires additional spending authority due to changes in workload or legislation, a formal Budget Change Proposal process is in place to accommodate the request.

The Department has the authority to assess up to \$2.20 per thousand dollars of total assets. The current assessment is \$1.36 or 62% of the maximum assessment rate; therefore, a contingency budget plan would consist of an increase in the assessment rate. Over the previous three years, the Department has expensed more funds than it has taken into income. The minimum cash balance of a three month reserve is maintained.

Overall, the budget is adequate to fulfill the statutory mandates and responsibilities of the Department. The Department obtained 88% in fiscal year FY 2005 from the general assessment based on the assets of the depository and other financial entities supervised. The remaining 12% was from various fees and interest on the fund. The general assessment is billed to the industry annually.

PERSONNEL

The Department's online Policy and Procedures Manual addresses communications, examinations, legal issues and personnel topics. The Employee Administrative Manual covers compensation, hours of work and overtime, holidays, leave, employee benefits, business and travel allowances and reimbursements, employee rights, performance evaluations, discipline and standards of conduct, grievance and arbitration procedures, award programs, training, selection, career development, classification, telework, transfer, layoff, retirement and health and safety issues.

California State Personnel Board Job Specifications provide duties and responsibilities for all classifications in State service, the minimum qualifications and required knowledge, skills and ability. All positions except the Commissioner, Chief Deputy Commissioner, Senior Deputy, Deputy Commissioner for Credit Unions and General Counsel are classified as civil service. Employee positions below the Financial Institutions Supervisors positions are represented by the union. Although most of the Department employees are not members, dues are deducted from their pay. The Governor appoints the Commissioner with confirmation by the legislature. The other non-civil service positions are appointed by the Commissioner.

Hiring policies continue to be adequate. The direct supervisor, who has received adequate training in conducting interviews, participates in the interview process. The organizational structure of the Department and the nature of the bank examiner positions provide adequate career advancement opportunities. Bank examiner positions include: Financial Institutions Examiner (FIE) A, B, C, Senior FIE, Financial Institution Supervisors and Financial Institution Managers.

The performance appraisal and review process is satisfactory. An integral part of the appraisal process is setting goals or establishing the performance plan for the next periodic review, including training needs and/or expectations. Although there is a means for pay for performance, the compensation is minimal and not utilized consistently throughout the Department. The Review Team suggests that the Superior Accomplishment Reward be utilized consistently and that the Department attempt to find more beneficial ways to pay for performance. Without adequate funding to reward exceptional employees, the appraisal process is not optimally effective.

The average turnover for the past five years has been 5.5%. Although current salaries are comparable with those paid by adjacent states, they are not comparable with those states who supervise the same type and complexity of financial institutions. Refer to the Review Team recommendations for further comments. The Department is currently subject to a salary freeze. The longer the freeze continues, the greater the discrepancy between salaries paid to California examiners and those paid to Federal regulators and to examiners in contiguous states. Another likely impact would be the recurrence of expensive turnover in Department staff.

TRAINING

Support for and encouragement of training is adequate for the training needs of the Department. The responsibility for formal training is assigned to the Department's Training Officer along with two assistants. Evaluations are completed by examiners who attend formal training at the conclusion of the training session.

The Department's training policy addresses both training for entry-level personnel and continuing professional education to existing examiners. Newly hired examiners and trainees must attend core training with continued training based on identified needs and on courses requested by the employee through the Individual Development Plan process.

The Department has a California specific Bank Examination Policy and Procedures Manual designated to supplement the federal agencies reference manuals. The Department has also developed a Trust Examination Procedures Manual. The examination reference materials are maintained by the Department's Policy Committee.

On-the-job training is accomplished by the Financial Institution Supervisors who provide training and mentoring to the Financial Institution Examiners. There is a very comprehensive checklist – Examiner Development Tracking Report, which includes the areas for which a trainee will receive training to become a fully qualified examiner. However, the checklist is not utilized consistently throughout the Department. The Review Team suggests that a means for assurance of consistent utilization of the checklist be established. Trainers and mentors are to complete Training Conclusion Forms and trainees are to complete Field Development Feedback Forms at the end of each examination.

The Department encourages and regularly participates in Graduate Banking and Trust Schools, Leadership Development Programs, MBA Programs and college and university extension courses. The Department pays for full or partial tuition and expenses and provides administrative leave.

The Department has adequate funding to meet its training needs. Amounts expensed for training in fiscal years 2005, 2004 and 2003 amounted to 2.2%, 2.0% and 1.6% of total expenditures respectively.

EXAMINATION

Examination frequency policies meet Accreditation Program requirements. State statutes require each state-chartered bank to be examined at least once every two calendar years. Department policy requires that all banks receive an annual examination; however, the Department has signed Alternating Examination Agreements with Federal regulators which meet Federal examination frequency guidelines and allow the acceptance of Federal examinations in lieu of a State examination. The Department has met its examination policy and statutory requirement for examination frequency for several years.

The Department is a signatory to the Nationwide Cooperative Agreement and the Nationwide State/Federal Supervisory Agreement, as well as the Nationwide Cooperative Agreement for Examination of Multi-State Trust Institutions and the Nationwide Foreign Banking Organization (FBO) Supervision and Examination Coordination Agreements. Cooperative/alternating examination agreements have been entered into with the FDIC and the Federal Reserve Bank of San Francisco. The Department has not signed any letter agreements with other States regarding interstate branching and the Department does not have a written interstate policy. The decision was made by the Department not to assess for assets held by California licensees in other states. An interstate contact has been designated to address compliance, billing and communications with affected states. The Review Team suggests that the interstate procedures in practice by the interstate contact be put in a written format.

Examination manuals include memoranda incorporated into a California Policies and Procedures Manual as well as various federal manuals. An examination manual for the trust area has also been developed. Procedures for scheduling and pre-planning of examinations appear adequate with examiners receiving approximately four to six weeks advance notice of their next assignment.

An adequate number of examiners are proficient in the conduct of commercial bank safety and soundness examinations with the possible exception of the capital markets area. Although there are examiners trained in the capital markets area, interviews indicated that in the very large complex banks conducted on a joint basis, examiners rely on the Federal regulators for review of this area. The continued training of selected individuals would enhance the Department's expertise on capital market issues. The results of the migration analysis performed on composite ratings over the past five years, was inconclusive since it did not result in a significant variance in downgrades between

State and Federal regulators.

An adequate number of examiners have received training in and conduct examinations of the specialty areas of trust, international agencies and foreign bank branches, bank holding companies and compliance with State and Federal Laws. The Department has the authority to examine bank holding companies. Although all SFIE's and FIE C's have received training in holding company examination, the performance of such examinations is not consistently utilized in compliance with the work program guidelines. The Review Team suggests that a review of all bank holding companies be performed at each examination of the subsidiary banks in accordance with the work program guidelines.

Basic information technology (IT) training is a core training course and all SFIE's and the majority of the FIE C's have received training. However, it was noted during the interview process that Department examiners continued to rely on their Federal counterparts in the case of joint examinations. The Department only has two SFIEs who would be considered as specialists in this area, and it is suggested that additional examiners be given advanced IT training. Additionally, the Department has not participated in the examination of a service provider in several years. Refer to the Review Team recommendations for further comments.

Examination report review procedures appear to be satisfactory. The transmittal letter is drafted by FIM's and responses are generally reviewed by the EIC. If an enforcement action is placed on the bank, the appropriate Deputy Commissioner is also involved in the review and response process. Some issues found in the report of examination and addressed in the transmittal letter appear to be repeated from year to year. The Review Team suggests that the follow-up practices and procedures place more emphasis on the correction of problems between examinations.

The Department's examination report processing turnaround time for 2005, 2004, and 2003 is 29, 36, and 46 days, respectively. Management is commended on their efforts to reduce the report turnaround time.

SUPERVISION

The HORUS Early Warning/Offsite Review System used by the Department is adequate. The Department is also in the process of implementing a System to record and track major items of exception and actions requiring follow-up. Exceptions noted by the surveillance program are communicated to the appropriate FIM for supervisory review. Follow-up on any concerns noted include telephone contacts, correspondence, visitations, target examinations, etc. Findings and results of communication with bank management are discussed with the regional Deputy and included in the monthly problem licensee report and discussed at the Problem Licensee Committee meeting with the Commissioner, Chief Examiner, Deputy and Assistant General Counsel. HORUS workbooks are stored on a share network drive and accessible by examiners for pre-examination planning purposes.

Enforcement authority includes the ability to issue cease and desist orders, including

emergency powers; remove an officer, director, or trustee; and assess civil monetary penalties. Although the use of available statutory enforcement authority has been adequate and appropriate, the removal powers are situation specific and, absent the pursuit of a civil or criminal action, do not prohibit employment of a removed person by any other financial institution. The Department cannot “remove” an individual if they have resigned or left the bank prior to initiation of the removal process. There are no direct enforcement powers over bank holding companies although criminal actions can be taken by the Department of Corporations. Refer to the Review Team recommendations for further comments. Use of existing enforcement authority is satisfactory.

LEGISLATIVE POWERS

The California Banking Law provides the Department and/or the Commissioner adequate authority to perform prescribed duties and responsibilities. The Department is also an active participant in the legislative process, and is able to provide input on any legislation affecting the Department or its licensees.

The Banking Law was last recodified in 1951. The last complete review was conducted over the last year and a half with no recommendations for any wholesale changes to the law. Since the last recodification, the Legislature has granted additional powers as necessary to improve the Department’s performance. The Department is one of fourteen departments within the Business, Transportation and Housing Agency. The Secretary of Business, Transportation and Housing Agency is a member of the Governor’s Cabinet. The Department initiates legislative proposals that are reviewed and considered by the Agency and the Governor’s Office annually.

By: _____
Lawrence E. Morgan, Team Leader

Franklin D. Dreyer

James L. Sexton

{Signatures on file}

REVIEW TEAM MEMBERS

The members of the Re-Accreditation Review Team for the evaluation of the California Department of Financial Institutions were:

Lawrence E. Morgan, Team Leader - Mr. Morgan has thirty-three years of increasingly responsible experience with the Federal Deposit Insurance Corporation (FDIC). He served with the Division of Supervision (DOS) at all levels, including Regional Director, and an extensive detail as the Deputy Director in Washington, D.C., serving as the second highest executive in the Division. From 1997 through 2002, he served as Regional Director in both Atlanta and Kansas City. Prior to that, he served as Deputy Regional Director in Dallas and Assistant Director in the Planning and Program Development Branch in Washington, D.C. Mr. Morgan currently works as a consultant and is an Advisory Director for a bank in Fort Worth, Texas.

Franklin D. Dreyer - Mr. Dreyer joined the Federal Reserve Bank of Chicago in 1958 as an Assistant Examiner. During the ensuing years, he reached the rank of Vice President, assuming the responsibility for other areas of the Supervision and Regulation Department. For the year 1987, Mr. Dreyer served as Deputy Director, Division of Banking Supervision and Regulation, at the Federal Reserve Board of Governors in Washington, DC. Upon his return to Chicago, he was named Senior Vice President of the Federal Reserve Bank of Chicago, with responsibility for all bank and bank holding company supervision and the Reserve Bank lending function. He retired from the Federal Reserve Bank in 1996. He is now active as a member of the board of directors of a Chicago financial institution and serves on various board committees.

James L. Sexton - Mr. Sexton retired as FDIC's Director of Supervision on September 29, 2000, where he was responsible for the safety and soundness of all FDIC insured banks and for the oversight of 2,000 bank regulatory personnel and their staff support. He also was a member of the Basel Committee on Banking Regulation. He joined FDIC in 1965 as a bank examiner in Fort Worth, TX. Succeeding promotions took him to Dallas, Memphis, Philadelphia and Washington where he served as the Deputy Director of Supervision and shortly thereafter the Director of Supervision. Mr. Sexton resigned from FDIC in 1983 and returned to Texas to become Banking Commissioner. During this period, Jim was active in the Conference of State Bank Supervisors, and in 1986 became the president-elect of that organization. Later in 1986, Mr. Sexton resigned his position as Banking Commissioner of Texas to enter the foreign and domestic bank consulting business. On January 3, 1999, Jim returned to Washington at the FDIC to complete his career there, taking up where he left off, as Director of Supervision. He currently serves as an advisory director on a bank board and as an expert witness on certain matters related to financial institutions.

Individually and together, the Review Team for the State of California possesses the capability to evaluate the Department's capacity to serve the citizens of California. The team members know the requirements of a capable banking department, what a department must do to protect the public interest and how bank examination, supervision and regulation can best encourage banks to provide needed services.

STATISTICAL OVERVIEW

	<u>12/31/2002</u>	<u>12/31/2003</u>	<u>12/31/2004</u>	<u>12/31/2005</u>
No. of State-Chartered Institutions:				
Commercial Banks	185	186	174	187
Non-Deposit Trust Companies	12	12	11	11
Savings Banks	1	1	0	0
Industrial Banks	19	16	15	15
Foreign Banks	43	40	38	38
Bank Holding Companies	132	128	110	105
State-Chartered Assets (in millions):				
Commercial Banks	\$148,670	\$139,544	\$158,765	\$191,869
Non-Deposit Trust Companies	\$575	\$598	\$586	\$675
Savings Banks	\$338	\$418	\$0	\$0
Industrial Banks	\$12,607	\$13,446	\$13,705	\$15,678
Foreign Banks	\$16,778	\$16,721	\$15,351	\$16,400
No. of Full-Scope Exams Completed:				
Commercial Banks	102	97	108	97
% examined	55%	52%	62%	52%
Non-Deposit Trust Companies	1	8	2	6
% examined	8%	67%	18%	55%
Industrial Banks and FBO's	35	23	22	24
% examined	56%	41%	42%	45%
Bank Holding Companies	57	49	54	51
% examined	43%	38%	49%	49%
Number of Depositories Examiners:	106	108	107	106

Commercial/Savings Bank Distribution by Asset Size:

> \$1 billion	35
\$500 million - \$1 billion	24
\$100 million - \$500 million	80
< \$100 million	48
Total Number Commercial Banks	187
Avg. Commercial Bank Size =	\$1,026,037,476

Other Financial Institutions Supervised by the Department:

Credit Unions	208	Payment Instrument Issuers	10
Premium Finance Companies	105	Travelers Check Issuers	4
Money Transmitters	60	BIDCO	1

Office of Commissioner of Banks Personnel

Acting Commissioner	1
Chief Examiner	1
General Counsel	1
Deputy Commissioner	5
Support Positions	14
Financial Institution Managers	7
Bank Examiners *	87.5
Legal Division	11
Credit Union Division	29
Administration & Policy	34
Support Positions	16
Total Department Staff	206.5
Total Allocated Positions	215

Bank Examiners*:

FI Supervisor	7
Senior FIE	39.5
FIE C	23
FIE B	5
FIE A	13
	87.5

Note: Retired Annuitants 9 (Four in Banking)

*Average length of service for bank examination staff is approximately 10.3 years.

Bank Regulation Budget Data (000's):

	<u>FY 03</u>	<u>FY 04</u>	<u>FY 05</u>	<u>FY 06</u>
FY end June 30				
Total Budget	\$16,310	\$17,378	\$18,845	\$18,788
Actual Expenditures	\$15,820	\$16,898	\$18,301	\$11,140
Actual Revenue	\$13,802	\$16,824	\$18,188	\$18,331

Balance of Designated or Cash Fund	\$5,497	\$4,790	\$5,906	\$5,636
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**FY 2006 budget data includes projected revenue and year to date expenditures as of 1/31/06.